DEPARTMENT OF STATE REVENUE

02-20130268.LOF

Letter of Findings: 02-20130268
Corporate Income Tax
For the Years 2008, 2009, and 2010

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.

ISSUES

I. Corporate Income Tax - Inter-Company Interest.

Authority: IC § 6-3-1-3.5; IC § 6-3-2-2; IC § 6-8.1-5-1; I.R.C. § 63; Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Indiana Dep't of Revenue v. Endress & Hauser, Inc. , 404 N.E.2d 1173 (Ind. App. 1980)

Taxpayer challenges the Department's decision to add back interest expenses claimed on its Indiana corporate income tax returns.

II. Corporate Income Tax - Royalty Expenses.

Authority: IC § 6-3-2-20.

Taxpayer maintains that the Department's decision to add-back royalty expenses was unconstitutional.

III. Corporate Income Tax - Net Operating Losses.

Authority: IC § 6-8.1-5-1.

Taxpayer states that the Department's decision to disallow net operating losses was unwarranted.

IV. Tax Administration - Underpayment Penalty.

Authority: IC § 6-3-4-4.1; IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests that the ten-percent underpayment penalty should be abated.

STATEMENT OF FACTS

Taxpayer is a multi-national manufacturer of industrial products with multiple Indiana business locations. Taxpayer and its affiliates filed separate Indiana income tax returns. The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's business records and tax returns. The audit resulted in the assessment of additional income tax. Taxpayer disagreed with the assessment on multiple grounds and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representative explained the basis for the protest. This Letter of Findings results. Additional facts will be provided as needed.

I. Corporate Income Tax - Inter-Company Interest.

DISCUSSION

On the ground that Taxpayer's method of reporting its Indiana adjusted gross income did not "fairly reflect" its Indiana source income, the Department proposed certain adjustments which resulted in the assessment of additional tax.

The Department reallocated inter-company interest expenses claimed by Taxpayer on its original Indiana return. The Department cited to provisions in Indiana law as authority to reallocate the inter-company expenses.

The Department's audit arrived at its adjustment under authority of IC § 6-3-2-2(l) and (m):

> (l) If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
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> (1) separate accounting;
> (2) for a taxable year beginning before January 1, 2011, the exclusion of any one (1) or more of the factors, except the sales factor;
> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.
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> (m) In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

During the years under audit, Taxpayer's gross profit was approximately 4.213 billion dollars. That amount was offset on the original return by approximately 4.194 billion dollars in interest expenses. Of that total interest amount, 93 percent was inter-company interest expense (Taxpayer borrowed the money from its affiliates and paid interest to those affiliates.) The audit report addressed the inter-company interest expenses as follows:

> There is so much inter-company interest expense because inter-company liabilities are increasing indicating existing inter-company liabilities are not being paid and/or additional liabilities are being incurred.

In addition, the audit pointed out that for the prior ten years, "[T]axpayer has reported net operating losses on its Indiana IT 20 returns. Except for the gross income tax in 2001 and 2002, the Taxpayer has not paid adjusted gross income tax for the last ten years."

The audit explained that Taxpayer reported a net operating loss of approximately seven billion dollars during the prior ten years while - on a consolidated basis with its affiliates - it reported over ten billion dollars in "Net Fed Tax Income" based on its federal returns. As a result of its accumulated interest liabilities, Taxpayer's "Total Liabilities Including Negative Cash [account balance]" increased to approximately 38 billion by 2010.

In contrast to Taxpayer, the audit noted that Taxpayer's reporting method enabled its affiliates to "earn the most money" because "they all have large interest income, limited expenses such as payroll, [and] rent expense . . ." because "Taxpayer pays the expenses to operate these entities even if only to oversee their activities." According to the audit report:

> It appears the only reason the Taxpayer can continue doing business while insolvent is due to the strong financial position of its affiliates. The Taxpayer has access to the liquidity of the affiliates through its centralized treasury function which "sweeps cash" from affiliates into the main bank account administered by the Taxpayer.

The audit concluded that "the [Taxpayer's] adjusted gross income as reported is without exaggeration, not fairly reflected. Such assertion is based on the fact that as a technically insolvent entity, it cannot survive on its own on an arms-length basis" and that "the inter-company loans are nothing more than an elaborate attempt to shift income away from separate return states."

The audit stopped short of requiring Taxpayer and its affiliates to file a combined return on the ground that "this solution is available only when there are no other alternatives . . . available." Instead:

> The audit proposes to add back to the net federal taxable income, the inter-company interest expense per the provisions of IC 6-3-2-2[](l) and (m). While this solution does not address all the sources of distortion of adjusted gross income, it appears this solution corrects the major source of such distortion.

To thereafter account for the claimed interest expense, the audit "allocate[d] a portion of the interest expense to

other subsidiaries . . . using the ratio of the sales of Taxpayer and other affiliates to the total sales."

Taxpayer objects on the ground that Indiana law does not permit the adjustment as proposed in the audit. Taxpayer cites to IC § 6-3-1-3.5 and concludes that "Indiana 'adjusted gross income' is defined by I.R.C. § 63 taxable income, as modified by IC § 6-3-1-3.5, 'no more, no less.'" Taxpayer argues that the audit's conclusion is a "red herring, as there is no authority for changing [Taxpayer's] federal taxable income or Indiana adjusted gross income other than as expressly prescribed in IC § 6-3-1-3.5."

Taxpayer explains that it "computed 'adjusted gross income' in compliance with IC § 6-3-1-3.5(b) . . . start[ing] with federal taxable income as determined under I.R.C. § 63, and then made the modifications to taxable income as required by IC § 6-3-1-3.5(b)." Taxpayer concludes that the audit is improperly and arbitrarily attempting to change the definition of "taxable income" as strictly defined in IC § 6-3-1-3.5.

In addition, Taxpayer cites to Indiana Dep't of Revenue v. Endress & Hauser, Inc. , 404 N.E.2d 1173 (Ind. App. 1980) to support its argument that, for Indiana purposes, Taxpayer's adjusted gross income is always identical to taxable income as defined in I.R.C. § 63. In Endress, the petitioner was a former Massachusetts business which relocated to Indiana. Id at 1173-74. The petitioner filed Indiana income tax returns reporting "no adjusted gross income . . . as a result of deducting . . . net operating losses suffered in Massachusetts." Id. The Department disallowed the net operating losses, petitioner paid the additional tax, and then filed a refund claim which the Department denied. Id. The trial court ordered the Department to refund the additional tax and the Department appealed. Id. The court stated that the issue was "whether or not the Indiana statute require[d] that a recognized federal deduction be disallowed or added back in to compute Indiana adjusted gross income." Id at 1176. The court stated that, "Under the unique set of facts of this case there is really no need for the Department to discuss apportionment or IC § 6-3-2-2 because there was no adjusted gross income to apportion." Id. The court held that it could "not extend the definition of adjusted gross income by an interpretation for there is no verbal basis in the Act." Id at 1178 .

Taxpayer argues that its situation is identical to that of the petitioner in Endress. "[Taxpayer] like Endress, had no IC § 6-3-1-3.5 adjusted gross income, but rather had a loss, and as a result, the apportionment provisions of IC § 6-3-2-2 do not come into play."

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." See also Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Taxpayer's essential argument is that having arrived at federal adjusted gross income under I.R.C. § 63, the Department is precluded from resorting to the "fairly represent" remedies set out in IC § 6-3-2-2(l), (m). As explained by Taxpayer, its adjusted gross income is calculated under I.R.C. 63 "no more, no less." The Department must disagree. In circumstances such as described, Taxpayer's interpretation would effectively render IC § 6-3-2-2(l), (m) a nullity. Although reported for federal purposes, Taxpayer's 3.85 billion dollar claimed interest expense is essentially irrelevant. As explained in the audit report, "[T]hese inter-company transactions do not affect the federal income tax liability nor do they affect the state income tax liability of the Taxpayer in its home state . . . where it is taxed on a combination basis. On the federal return and the combined return filed in . . ., inter-company expenses are eliminated." While the interest expenses for federal purpose and its home-state may be irrelevant for federal purposes, they have a significant effect on Taxpayer's Indiana tax liability. Taxpayer essentially negates its state tax liability by claiming interest expenses for money borrowed from its own affiliates on loans for which there is no indication it has or ever will repay.

The Department also disagrees that the court's decision in Endress is dispositive of the issue. In that case, there was no indication that the petitioner's claim to net operating losses, garnered while it was located in another state, somehow distorted its then pending state liabilities. In that case, the Department relied on a provision contained in "Circular IT-82" in order to disallow the claimed net operating losses sustained while Endress was located in Massachusetts. In this case, the Department agrees that Indiana adjusted gross income starts with federal adjusted gross income as defined in I.R.C. § 63. Where the Department departs from Taxpayer's analysis is whether the IC § 6-3-2-2(l) and (m) "fairly represent" remedies are available to determine what the Department quite reasonably believes would "fairly represent the taxpayer's income derived from sources within the state of Indiana . . . ."

The audit's decision to reallocate the $3.85 billion of interest expense was an entirely reasonable attempt to "effectuate an equitable allocation and apportionment of the taxpayer's income" which is supported by both the facts and law.

FINDING

Taxpayer's protest is respectfully denied.

II. Corporate Income Tax - Royalty Expenses.

DISCUSSION

On its original return, Taxpayer "deducted royalty income and amortization of intangible property expense when it computed the add-back of royalty expense in the federal return." The audit cited to IC § 6-3-2-20 when it found that "the royalty expense deducted in the federal return should be added back."

In relevant part, the provision requires:

> (b) Except as provided in subsection (c), in determining its adjusted gross income under IC 6-3-1-3.5(b), a corporation subject to the tax imposed by IC 6-3-2-1 shall add to its taxable income under Section 63 of the Internal Revenue Code:
> (1) intangible expenses; and
> (2) any directly related intangible interest expenses; paid, accrued, or incurred with one (1) or more members of the same affiliated group or with one (1) or more foreign corporations. IC § 6-3-2-20(b).

Pursuant to IC § 6-3-2-20, the general rule is that a taxpayer must add back its otherwise qualified deductions, unless the taxpayer can demonstrate its deductions satisfy at least one of the exemptions afforded by IC § 6-3-2-20(c). Thus, in this case, for the deductions claimed for tax years beginning after June 30, 2006, taxpayers must add back the deductions unless they can demonstrate that their deductions qualify one of the exemptions outlined in IC § 6-3-2-20(c).

Taxpayer objects on constitutional grounds. According to Taxpayer, "The royalty expense add-back rules contained with IC §§ 6-3-1-3.5 and 6-3-2-20 clearly violate the Due Process and Commerce clauses of the United States Constitution by inextricably linking the ability to deduct expenses with the amount of tax a related company may have paid in another state."

Taxpayer claims that the addback provision "is not fairly attributable to the economic activity in Indiana because Indiana completely disregards the add-back of the payment to a related company if it can be shown that the related party paid tax on such income in another state." According to Taxpayer, this exception "demonstrate[s] that there is no[] rational relationship between the income attributed to the State and the interstate values of the enterprise."

Taxpayer challenges not the local application of IC § 6-3-2-20(c) but the constitutionality of the provision itself. However, an administrative proceeding is not the appropriate venue in which to raise constitutional issues.

FINDING

Taxpayer's protest is respectfully denied.

III. Corporate Income Tax - Net Operating Losses.

DISCUSSION

The Department's audit disallowed net operating loss deductions accumulated during years prior to 2008. According to the audit report:

> It appears the Taxpayer's reporting procedure during the current audit which results in large separate-company net operating losses, large inter-company interest expense, and large consolidated net federal taxable income has been consistently applied since 2001. It would appear that if an audit of these prior years would also disallow the inter-company interest expense and allocate part of the third-party interest expense to affiliates; there would be no net operating losses in these prior years.

Taxpayer objects on the ground that "[t]here is no basis in law for denying [Taxpayer's] net operating loss carry forwards . . . and that the "Auditor engaged in no analysis of [Taxpayer's] facts and circumstances for the years in which those losses were incurred."

The audit disallowed net operating losses accumulated prior to the years directly under audit. The amount of losses is not an insubstantial number; Taxpayer claimed approximately 4.740 billion dollars in interest expenses from 2001 through 2007. While the audit does not detail these expenses in the same detail as it did for the years under audit, Taxpayer's response is a bare averment of the Department's decision and is insufficient to meet the burden set out in IC § 6-8.1-5-1(c) which requires that the Taxpayer establish that the proposed assessment is "wrong."

FINDING

Taxpayer's protest is respectfully denied.

IV. Tax Administration - Underpayment Penalty.

DISCUSSION

Taxpayer maintains that the assessment of a ten-percent penalty is unwarranted and that the Department should exercise its authority to abate the penalty. Taxpayer concludes that "these bare Proposed Assessments are inherently arbitrary and capricious, and contrary to law."

The Department assessed Taxpayer underpayment penalties because it failed to timely remit its estimated payments of adjusted gross income tax for the 2008, 2009, and 2010 tax years pursuant to IC § 6-3-4-4.1(d). Taxpayer seeks abatement of the underpayment penalties.

IC § 6-3-4-4.1(d) states:

> The penalty prescribed by IC 6-8.1-10-2.1(b) shall be assessed by the department on corporations failing to make payments as required in subsection (c) or (f). However, no penalty shall be assessed as to any estimated payments of adjusted gross income tax which equal or exceed:
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> (1) the annualized income installment calculated under subsection (c); or
> (2) twenty-five percent (25 [percent]) of the final tax liability for the taxpayer's previous taxable year.
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> In addition, the penalty as to any underpayment of tax on an estimated return shall only be assessed on the difference between the actual amount paid by the corporation on such estimated return and twenty-five percent (25 [percent]) of the corporation's final adjusted gross income tax liability for such taxable year.

IC § 6-8.1-10-2.1(b)(4) imposes the "underpayment" penalty at ten-percent of "the amount of deficiency as finally determined by the department . . . ." IC § 6-8.1-10-2.1(d) states that, "If a person subject to the penalty imposed under this section can show that the failure to . . . pay the full amount of tax shown on the person's return . . . or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall wave the penalty."

Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case by case basis according to the facts and circumstances of each taxpayer." Id.

Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

The Department believes that Taxpayer substantially erred in determining its corporate income tax liability. However, based on a "case by case" analysis and after reviewing the facts and circumstances of this Taxpayer, the Department agrees that the ten-percent underpayment penalty should be abated.

FINDING

Taxpayer's protest is sustained.

CONCLUSION

Taxpayer's protest of the underpayment penalty is sustained. The remainder of Taxpayer's protest is denied.

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